Chapter One

Introduction

Problems in the banking industry proliferated dramatically during the 1980s, and the number of bank resolutions reached levels not seen since the Great Depression. Since the Banking Act of 1933 established the Federal Deposit Insurance Corporation (FDIC), more than 2,000 troubled commercial and savings banks have been resolved. Banks resolved by the FDIC have either failed, requiring regulatory involvement in their exit from the industry, or needed some financial assistance to remain open. Between 1980 and 1992, the FDIC resolved almost three times as many banks (1,505 banks) as it resolved in the first 46 years of its existence (at many times the cost to the insurance fund). During the peak years between 1987 and 1992, the FDIC resolved more than 1,000 banks, seriously depleting the Bank Insurance Fund (BIF).

Before 1980, the solvency of the insurance fund was never an issue. Until the mid-1980s, revenues to the insurance fund, primarily derived from semiannual assessments of premiums, invariably exceeded losses. Regulators assessed premiums at the same flat rate used since the creation of the fund--8.3 cents per $100 of insured deposits. At the time, the FDIC (with Congressional authorization) commonly provided rebates of up to one-third of the overall annual premium assessments to avoid generating what was commonly thought of as an "excessive" insurance fund surplus.[1] Regulators considered the fund reserves more than sufficient to handle recognized fund losses, feeling that it was not necessary to increase premiums. In 1987, the BIF had an $18 billion reserve. But by 1991, the record number of resolutions had caused such a drain on insurance fund reserves that the General Accounting Office pronounced the Bank Insurance Fund insolvent.[2]

The dramatic increase in the number and costs of resolutions in the late 1980s, coming on the heels of the savings and loan crisis, brought into question the long-term condition of the deposit insurance fund. Taxpayers have paid dearly for the savings and loan insurance losses, a financial hemorrhage that may cost more than $150 billion (expressed in 1990 dollars) before it is finished.[3] Speculation that taxpayers would again have to come to the rescue of another ailing insurance fund sparked Congressional debate.

In addition to the immediate problem of losses to the Bank Insurance Fund, industry analysts were also concerned about the broad economic effects of bank failures. The average loss in asset value of banks and thrifts resolved during the 1980s was unprecedented in the history of deposit insurance. These losses were symptomatic of poor decisions by many depositories and weaknesses in the regulatory system of monitoring and supervision. Another

1. William E. Gibson, "Deposit Insurance in the United States: Evaluation and Reform," *Journal of Financial and Quantitative Analysis* (March 1972), pp. 1575-1594.

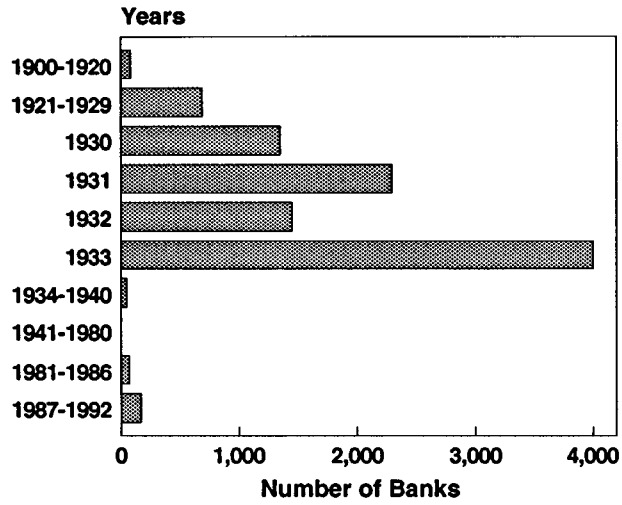
2. General Accounting Office, "Financial Audit: Bank Insurance Fund's 1991 and 1990 Financial Statements" (report to the Board of Directors, Federal Deposit Insurance Corporation, Washington, D.C., May 11, 1992). The insurance fund is *insolvent* when there are not sufficient reserves on hand to manage bank failures. Technically, however, the fund is never *illiquid* because the FDIC has the ability to borrow funds (up to $30 billion as of 1991) from the U.S. Treasury to handle resolutions and maintain working capital.

3. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1995-1999* (January 1994), p. 44.

cause of concern is that bad investments made with funds from depository institutions may have contributed to an overvalued capital stock and poor growth of productivity in the United States during the 1980s.

The alarming increase in the number of bank (and thrift) resolutions revealed the necessity for bank reform legislation. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) were responses to the pressure put on the deposit insurance system because of the costs of resolving these institutions. As a result of these legislative actions and an increase in banking industry profits in 1992 that continued into 1993, concerns have abated somewhat. Among the most interesting questions remaining are why there was such an increase in bank failures and subsequent resolutions in the late 1980s and early 1990s. Also, why did the costs to the government of resolving failed banks increase so dramatically, depleting the BIF in just a few years?

Figure 1.
Average Annual Number of Bank Failures for Selected Periods Between 1900 and 1992



SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation.

Bank Resolutions in Historical Perspective

In the early history of the U.S. banking industry, from 1870 to 1919, banks failed at a rate slightly lower than that of firms in other sectors of the economy.[4] In fact, the industry grew rapidly during this period. The number of commercial banks tripled in 35 years, growing from 10,000 in 1885 to 30,000 in 1920. Almost 500 banks failed in 1893, but from 1900 to 1920 the average rate of failure was less than 100 a year.[5] Circumstances began to change, however, in the 1920s.

During the 1920s, the banking industry began to contract. As many as 5,400 banks suspended operations and more than 4,000 never reopened. Nearly 700 banks failed every year during the 1920s (see Figure 1). A recession hit the agricultural sector in the late 1920s, accounting for the failure of many small rural banks. The Great Depression struck the entire economy in the early 1930s, causing record numbers of bank failures.

Between 1930 and 1933, the average number of annual bank failures reached an incredible 2,274. Within the five years from 1929 through 1933, the number of banks in the United States was cut almost in half, to about 14,700. Even during these crisis years, annual losses to depositors rarely exceeded 1 percent of total deposits at all banks. Losses at many of these banks were generally limited to less than 10 cents on the dollar.[6]

4. George Kaufman, "Banking Risk in Historical Perspective," *Research in Financial Services: Private and Public Policies*, vol. 1 (Chicago: JAI Press Inc., 1989), pp. 151-164.

5. George Benston and George Kaufman, "Risks and Failures in Banking: Overview, History, and Evaluation," in George G. Kaufman and Roger C. Kormendi, eds., *Deregulation of Financial Services: Public Policy in Flux* (Cambridge, Mass.: Ballinger Press, 1986).

6. James S. Lawrence, "What is the Average Recovery of Depositors?" *American Bankers Association Journal* (February 1931), pp. 655-656, 722-723.

During this period, in the absence of a system of deposit guarantees, banks were declared legally insolvent and closed by their creditors much more quickly than they were after deposit insurance.[7] Liquidity was much more costly in early financial markets because funds moved slowly through the system. If banks could not meet liquidity requirements, they would often voluntarily suspend operations. Bank examiners would then determine whether a bank had sufficient capital to reopen. The fact that banks were closed fairly quickly in a liquidity crisis helped to limit depositors' losses.

It is popularly supposed that many of these failed banks had fallen victim to deposit runs. But from 1865 to 1929, fewer than 15 percent of all bank failures occurred as a result of depositor runs.[8] Surprisingly few solvent banks were drawn into failure as depositors reacted in panic to losses at other insolvent banks.[9] Although there were severe systemwide runs in the early 1930s, a large proportion of the banks that failed were insolvent. Banks that the Federal Reserve supported (in the role of lender of last resort) tended to survive.[10]

Banking After the Depression

After the banking crisis of the early 1930s, the Banking Acts of 1933 and 1934 created the FDIC. These acts made the FDIC responsible for resolving banks when the state or federal chartering agency declared them insolvent, and for maintaining an insurance fund to protect depositors. Deposit insurance was supposed to immunize the system as a whole against a contagious response to individual bank failures, but in so doing it transferred the burden of monitoring individual institutions from the creditors of depositories to regulators. Before the deposit insurance system put guarantees in place, several parties, including investors and depositors, were interested in reducing their risk of loss. The risk of losing depositors and shareholders (in the case of national banks) generally influenced banks to keep their portfolio risk low. Depositors also pressured banks to hold more capital because the greater the amount, the more losses the bank could withstand before becoming insolvent and forcing losses on depositors.

The Post-Depression Incidence of Bank Resolutions. From 1934 onward, bank runs were virtually nonexistent. The average annual rate of banks resolved by the FDIC dropped well below preinsurance levels (see Figure 1). From 1934 to 1940, the average annual number of bank resolutions dropped dramatically to 64. During the next 40 years, from 1941 to 1981, the average number of resolutions fell to only five banks a year. Bank resolutions began to rise again in the 1980s as changes in financial markets, lingering inflation, regulatory reform, and national and regional economic shocks contributed to an environment of structural change for financial institutions.

More than 100 banks had to be resolved every year between 1985 and 1992. The peak year during this period was 1989, when the FDIC resolved 207 banks. In an industry composed of between 11,000 and 12,000 commercial banks, even 200 resolutions in any one year may seem slight--a failure rate of less than 2 percent. But the number of resolutions in any one year is not as significant as the trend over several years. Between 1980 and 1992, the number of commercial banks in the industry shrank by more than 16 percent. This period saw the highest number of resolutions and the first significant challenge to the deposit insurance system in the history of the FDIC.

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7. Kaufman, "Banking Risk in Historical Perspective," pp. 151-164.

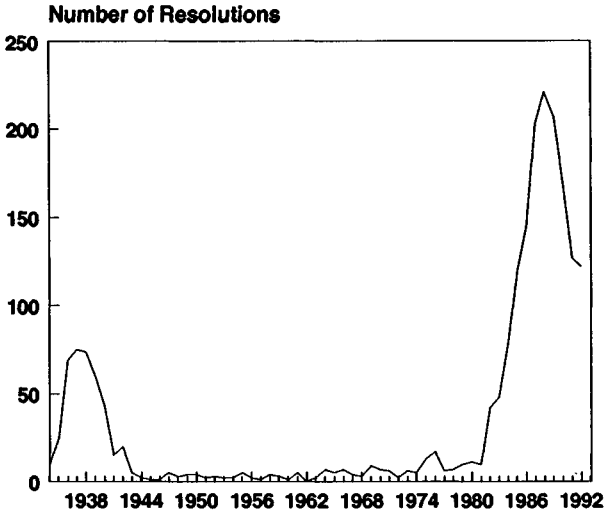
8. George Thorndyke, "Fiction and Fact on Bank Runs," *American Bankers Association Journal* (June 1929), p. 1,269.

9. Kaufman, "Banking Risk in Historical Perspective," p. 152.

10. See Allan H. Meltzer, "Financial Failures and Financial Policies," in George G. Kaufman and Roger C. Kormendi, eds., *Deregulation of Financial Services: Public Policy in Flux* (Cambridge, Mass.: Ballinger Press, 1986). Meltzer states that the Federal Reserve in the role of a lender of last resort should act to prevent illiquid but solvent banks from being forced to close by making loans to them when they face heavy deposit withdrawals.

    See also Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton, N.J.: Princeton University Press, 1963). The authors state that during the 1930s the Federal Reserve did not provide sufficient liquidity, whether through the discount window or open-market operations, and thousands of banks were forced to liquidate their assets simultaneously in depressed markets.

Figure 2.
Number of Bank Resolutions, 1934-1992



SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation.

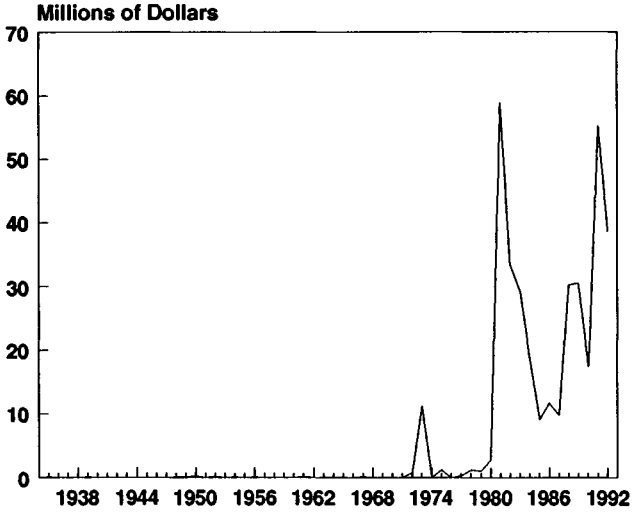
The Impact on the Bank Insurance Fund. The marked increase in resolutions, combined with dramatically higher average losses per institution, resulted in unprecedented losses during the 1980s (see Figures 2 and 3). For 45 years, from 1934 to 1979, the cumulative resolution costs associated with more than 560 failed banks totaled less than $559 million (in 1990 dollars).[11] From 1980 to 1992, cumulative resolution costs for some 1,500 banks exceeded $40 billion.

Not only were a record number of insured banks resolved during the 1980s, but the average size of a bank requiring resolution increased. The assets of all pre-1980 resolutions totaled less than $30 billion (in 1990 dollars), and banks resolved from 1980 to 1992 had assets of almost $330 billion (in 1990 dollars). The average size of a resolved bank in the period before 1980 totaled about $49 million (in 1990 dollars); after 1980, the average resolved bank held about $220 million in assets (in 1990 dollars).

Moreover, losses per dollar of assets increased dramatically for failed banks during the 1980s. In the 1934-1979 period, resolution costs, measured as losses to the fund, averaged about 2 percent of failed bank assets. In the 1980-1992 period, resolution costs per dollar of failed bank assets averaged 12 percent. Had resolution costs per dollar of assets remained at the pre-1980 historical average, losses during the 1980s through 1992 would have been more than 80 percent lower than the losses that actually occurred.

Throughout its history, the FDIC has been able to cover insurance claims with the revenues generated from premium assessments and other sources. In spite of the claims on the fund incurred by the rising number of resolved institutions in the early 1980s, the fund balance was $11 billion in 1980 and actually increased until 1987. In 1988, the second year in a row during which more than 200 banks were resolved, the FDIC suffered an operating loss--the first in the history of the fund--and the re-

Figure 3.
Average Resolution Costs for Resolved Banks, 1934-1992



SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation.

11. FDIC estimates of resolution costs for the 1934-1979 period are obtained from FDIC annual reports. Data were originally compiled in James R. Barth and John J. Feid, "Alternative Federal Deposit Insurance Reprises," Research Paper No. 152 (Federal Home Loan Bank Board, January 1989), but were not adjusted for inflation. This analysis corrects for inflation and uncertainties about the length of time necessary to dispose of assets after liquidation. Resolution cost estimates in this chapter are all in 1990 dollars.

serve ratio was less than 1 percent. The ratio of the insurance fund reserves to total insured deposits is a measure of the overall health of the fund. At the time the law required the FDIC to maintain the insurance fund at a minimum ratio of 1.16 percent. The reserve ratio continued to fall for the next three years and by the end of 1991 the fund had a negative balance.

The Congress enacted special legislation to provide the FDIC with sufficient funds to close insolvent banks and recapitalize the insurance fund. The Federal Deposit Insurance Corporation Improvement Act of 1991 gives the BIF authority to borrow up to $30 billion from the U.S. Treasury to cover the losses from bank resolutions.[12] FDICIA also enables the BIF to borrow additional funds for working capital--up to 90 percent of the value of the assets acquired from failed banks held by the FDIC --from the Federal Financing Bank (also a part of the U.S. Treasury). To recapitalize the BIF, FDICIA requires that the FDIC set assessment rates that will achieve a designated ratio of insurance fund reserves to total insured deposits of 1.25 percent by 2005. A minimum rate of 23 cents per $100 of insured deposits is required until the target ratio is achieved. In January 1993, the FDIC put into effect a "risk-based" premium structure with average premiums of approximately 25 cents per $100 of qualified deposits.

Banking Industry Changes and Consolidation. In one sense, industry analysts view the bank resolutions of the 1980s as the inevitable consequence of an industry undergoing fundamental changes while moving toward greater competitiveness and efficiency. Bank failures, like failures in any other business, can occur as unfortunate by-products of an industry experiencing intensive competition, deregulation, and structural change.

The deregulation of banking began in 1980 with the removal of statutory interest rate caps. Such industries as railroads, trucking, airlines, petroleum, and natural gas experienced consolidation and firm failures following deregulation. So, too, the banking industry underwent a period of consolidation and failures. Less efficient banks fell into insolvency as other banks and nonbank financial institutions competed to serve consumers in financial markets.

The numbers and costs of bank resolutions during the last decade, however, carry more onerous implications than a simple movement toward enhanced efficiency might suggest. The banking sector, despite partial deregulation, still operates under the supervision of state and federal chartering agencies and FDIC regulators. It is therefore important that regulators have an efficient exit policy for insolvent institutions because the longer an insolvent bank is permitted to operate, the greater the potential loss to the insurance fund. By the time regulators declared many failed banks legally insolvent during the 1980s, the value of assets had deteriorated so much that the cost of resolution greatly exceeded administrative costs. A bank is economically insolvent when the market value of its liabilities exceeds the market value of its assets. Without regulatory intervention, an insolvent bank can continue to operate independently until it cannot meet cash obligations; in other words, until insolvency becomes clearly noticeable. The large margin of losses over administrative costs is one indication that these banks had operated in an insolvent state for some time before they were resolved. Empirical analyses of the savings and loan crisis suggest that insolvent institutions that are closed earlier cost less to resolve.[13]

The high resolution costs of the 1980s brought into question the efficiency of regulatory supervision and the process of removing insolvent banks from the system. Regulators depended on traditional book-value methods of accounting that masked potentially insolvent banks until resolution costs became extraordinary. Unanticipated resolu-

12. Section 101 of the Federal Deposit Insurance Corporation Improvement Act of 1991, 12 U.S.C. 1824, 105 Stat. 2236.

13. R. Dan Brumbaugh, Jr., and Robert E. Litan, "A Critique of the Financial Institutions Recovery, Reform and Enforcement Act (FIRREA) of 1989 and the Financial Strength of Commercial Banks," in James Barth and R. Dan Brumbaugh, eds., *The Reform of Federal Deposit Insurance* (New York: Harper Business, 1992). See also Congressional Budget Office, "The Cost of Forbearance During the Thrift Crisis," CBO Staff Memorandum (June 1991).

tions raise fundamental concerns about the ability of regulators to limit future losses. In addition, allowing insolvent banks to continue operating can hurt healthy banks in the same market. Insolvent banks that remain open can increase the cost of doing business as they bid for potential customers.

The Economic Costs of Bank Failures

The primary function of the nation's financial system is to facilitate the efficient allocation of resources in the economy. As an important component of the financial system, banks provide mechanisms for facilitating transactions, transmitting monetary policy, and transferring funds between savers and borrowers--a principal ingredient of economic growth. Banks have been a primary credit conduit, especially for such information-intensive borrowers as small businesses.

The most frequently stated goal of banking regulation is to maintain the safety and soundness (or stability) of the financial system. As an important part of that system, banks provide a vital service to the economy and to society as a whole. Conditions that impede the ability of banks to operate efficiently affect the allocation of resources. If bank closings create a shortage in the amount of credit available, society bears the cost of lost investment opportunities and therefore lower economic growth. Circumstances that affect the stability of banking can also affect monetary policy.

The Direct and Indirect Costs of Bank Resolutions

The cost of bank failures involves more than just the losses that the FDIC reports to the insurance fund. Most failures throw bank employees out of work, causing them at least a temporary loss of full wages. But on the whole, bank resolutions during the last decade did not cause a major loss of jobs in the industry. Bank employment actually increased during most of the decade. Despite the reduction in the number of banks providing financial services, the number of branches did not decrease over the period. It was not until the early 1990s that several institutions started to contract and lay off workers, causing employment in the industry to fall slightly.

There may be, however, substantial indirect losses, particularly in those regions where there are larger numbers of resolved banks. Excessive bank failures in a particular region can temporarily increase the difficulty and costs of obtaining credit for small-to-middle-sized firms in the area. These firms usually depend on banks for commercial and industrial loans. Economic losses associated with bank resolutions can carry over to other industries if creditworthy businesses find it excessively costly to obtain credit as a result of a high rate of bank failures in a region.

In addition to indirect losses suffered by other businesses after bank failures, real economic losses can occur even before a bank fails and is resolved. Most financially weakened banks get that way because they lose money on poor-quality assets--mostly bad loans. For example, excessive investment in commercial real estate throughout the 1980s took the place of other, potentially more valuable, investments. Bad loans, which eventually show up as relatively high losses on an asset, equate to misallocated investment and lower economic growth. Many economists believe that the lack of productivity during the 1980s was, in part, the result of insufficient investment in productive resources. A Congressional Budget Office study of the failures of some 1,000 savings and loans suggests that the opportunity costs of misdirected investment by failed thrifts was substantial.[14]

14. See Congressional Budget Office, *The Economic Effects of the Savings & Loan Crisis* (January 1992).